CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY

FOR
SINGLE-FAMILY HOUSING PROGRAM

April 18, 2005

This Policy is effective immediately upon adoption and supersedes all previous single-family housing acquisition and development real estate investment policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for the Single-Family Housing Acquisition and Development Program ("the Program"). The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Program. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with single-family housing investment.

II. STRATEGIC OBJECTIVE

Achieving the highest total rate of return possible consistent with a prudent level of risk, the liabilities of the System and investment guidelines herein are the strategic objective of the Program.

The Program shall be considered a specialized component of the specialized equity real estate portfolio and, as such, shall be required to achieve an appropriate risk-adjusted return. The *primary* emphasis of the Program is in the state of California. The Program shall be managed to assist the System in achieving its overall long-term objective of exceeding a minimum target real rate of return of 8% (after fees) while maintaining a prudent level of risk.

The Program shall be managed to accomplish the following:

A. Preserve investment capital;

B. Generate attractive risk-adjusted rates of return for the System as a total return investor;

C. Provide a hedge against inflation; and

D. Consider solely the interest of the System's participants and beneficiaries in accordance with California State Law.

III. INVESTMENT APPROACHES AND PARAMETERS

A. **Risks**

There are risks associated with investment in the single-family residential housing industry. The primary risks include, but are not limited to, the following:

1. Land Entitlement Risk

    a. Land entitlement risk reflects the risks assumed by an investor when purchasing a parcel of land prior to the tentative map and other discretionary political approvals being granted by the appropriate regulatory bodies (i.e., municipalities or planning agencies, or both) as to the final use of the property.

    b. In order to limit this risk, the System shall invest primarily in land where a tentative map for the project has been obtained. The Program exposure to unentitled land shall generally not exceed 20% of the actual invested total Housing Program Portfolio.

2. Project/Development Risk

    a. Investment in single-family residential development and construction entails assuming the normal risks associated with development of this property type.

    b. These risks, some of which are controllable, include, but are not limited to, the following: cost overruns, project delays, contractor disputes, ineffective marketing, slow sales, price modifications, and potential litigation.

    c. Partners who are selected by the System to manage funds invested in this property type shall be expected to undertake all appropriate steps to mitigate these risks.

3. Interest Rate Risk

   a. Fluctuating interest rates affect the affordability of housing for all buyers, especially for price-sensitive first-time buyers.

   b. The risk to the investor and homebuilder is that the standing inventory of homes may remain unsold for an extended period of time.

   c. The risk can be mitigated by careful economic analysis of market cycles, limited project life cycles, controlled standing inventory (by limiting starts ahead of sales), and maintained flexibility on pricing.

   d. Interest rate risk can also be partially mitigated by using interest rate hedging.

   e. Partners who undertake to manage invested funds in this property type shall be expected to closely examine strategies to mitigate interest rate risks and execute such strategies when appropriate.

B. **Diversification**

The Program shall be well diversified to minimize risk due to overexposure to any one risk factor. The Program shall be diversified by geography, strategy, product type, price mix, builder, project, and development life cycle. From time to time, adjustments to correct the actual investment to comply with the Policy allocation ranges shall be implemented on an opportunistic basis over a reasonable time frame (normally within a three-year period) and with ample consideration given to preserving investment returns to the System.

The System shall periodically review the Portfolio and Program Guidelines. The System shall notify the partners when the Portfolio violates diversification guidelines and portfolio leverage.

1. Diversification by Geography

   The Program shall diversify by geography. Major urban and suburban markets and submarkets shall be considered, but not more than 25% shall be invested in any single Metropolitan Statistical Area (MSA). California is the current primary focus of the Program, but the System shall consider investments outside of California. In considering such investments outside of California, the System shall maintain or strive to increase commitments within California consistent with its fiduciary obligations. The geographic allocation shall be reviewed periodically to determine appropriate levels.

2. Diversification by Strategy

The System shall employ a broad range of strategies for Program investment. Allocation ranges for each strategy have been established and are listed below. To mitigate risk, the System shall place less emphasis on strategies carrying a greater degree of uncertainty.

Strategy	Allocation Range
Housing Joint Ventures	50 – 100%
Land Development	0 – 50%
Off-balance-sheet Financing	0 – 40%
Unentitled Land	0 – 20%
Entity Level Investments	0 – 10%
Related Investments	0 – 10%

The total allocation to land development, unentitled land, and off-balance sheet financing shall not exceed 50% of the Program.

3. Diversification by Product Type

Emphasis shall be placed on owner-occupied primary residences and entry-level housing. Other product types shall be considered, including, but not limited to, the following: first-time-move-up and second-time-move-up.

4. Diversification by Price Mix

The Program shall consider ranges of lot/home pricing that are appropriate within each region and submarket. Actual price levels shall be determined by specific markets and submarkets. The Program shall encourage, but not be limited to, affordable housing projects, which otherwise meet all prudent investment criteria. Pricing of homes shall be consistent with the first, second, and third-time buyers for the particular geographic market, within the limits otherwise established within the Policy.

5. Diversification by Builder

The Program shall consider diversifying among various builders to avoid business risk associated with a single partner entity. In the context of this Policy, "Builder" shall refer to either a homebuilder or a residential land developer. Builders shall represent expertise in a range and diversification of price mix and geography, and selection shall be based on financial strength and industry expertise. The desired Builders shall be leading developers with at least ten years' experience in the single-family housing or residential land development industry.

For the System's Investment Committee and Staff contemplating the construction of homes, the desired Builders shall be either leading homebuilders (top tier), or regional Builders with a niche focus on single-family residential development or affordable housing (second tier). For purposes of this Policy, a top-tier homebuilder is defined as one within the top 50 producers of homes within California (or the applicable state) during each of the last three years.

No more than 20% of total capital shall be committed to any one homebuilder. For the purposes of this Policy, entities that have substantial common ownership (greater than 10%) shall be considered a related entity; therefore, they shall be considered one Builder.

6. Diversification by Project

The Program shall diversify investments in such a manner that no one project shall dominate an individual partner allocation. No more than 35% of an individual Partner allocation, capped at $100 million, shall be invested in any single project without System approval.

7. Diversification by Development Life Cycle

The Program shall diversify investments such that the development life cycle shall vary. Development Life Cycle is the total time the project progresses from market entry to exit. The maximum time period for completion of the development cycle of acquisition, development, construction, and sellout shall generally be five years. The expected project life cycle, from acquisition of entitled or unentitled land through the completion of construction of the final home, should be five years or less. No project with a life cycle greater than five years is permitted without the Staff's approval, except where partnership investment capital is returned within five years.

C. **Investment Objectives and Criteria**

1. Housing Joint Ventures

a. "Housing Joint Ventures" refers to properties that are acquired with the intention to develop or construct homes (including all forms of development for single-family housing, such as condominiums, town homes, zero lot line developments, planned unit developments with and without common areas, and standard subdivisions).

b. Investment Criteria

(1) Generally, project size shall be limited to 400 units. Staff has the discretion to approve larger projects after reviewing investment parameters; and

(2) Each project shall be required to produce a minimum real rate of return (after fees) of 6%.

2. Land Development

a. "Land Development" refers to properties that are acquired with the intention to develop or construct infrastructure (including all forms of acquisition and infrastructure development for single-family housing, such as condominiums, town homes, zero lot line developments, planned unit developments with and without common area, and standard subdivisions).

b. Incidental Development

(1) Incidental commercial/multi-family infrastructure lot development may be undertaken in the Program, provided that it is not a major cost of the overall single-family project.

(2) Golf course construction may be undertaken provided that it is an essential or required component of the overall master plan for the single-family project. Furthermore, the business plan must contemplate liquidation of the golf course at or before the end of the project.

c. Investment Criteria

(1) All Land Development investment shall meet the following conditions:

(a) Comply with the general plan and zoning ordinance of the governing jurisdiction;

(b) Comply with the provisions of the California Environmental Quality Act (CEQA) in California, or comparable local, state and federal environmental quality laws in other states;

(c) Have an approved tentative map for the master development (tentative maps for individual parcels for sale to merchant builders are not required) or, as applicable, a development agreement approved by the governing jurisdiction; and

(d) Have received any other major discretionary approvals including those of the Coastal Commission and LAFCO, as applicable or comparable local, state, and federal agencies. This condition does not include the issuance of routine procedural approvals, (e.g., Department of Transportation, Fish & Game, Corps of Engineers, grading permits, building permits, or storm water discharge permits).

(2) Generally, project size shall be limited to no more than 3000 lots. The Staff has the discretion to approve larger projects after reviewing investment parameters; and

(3) Each investment shall be required to produce a minimum real rate of return (after fees) of 8%.

3. Off-balance-sheet Financing

a. "Off-balance-sheet Financing" is a financing structure that allows a developer to improve its land without carrying the land inventory on its balance sheet. Typically, the developer is a publicly held company ("Public Builder"). The System's housing partners shall acquire the unimproved land from the Public Builder. Concurrent with the execution of the purchase and sale agreement, the partnership and the Public Builder will execute an option agreement granting the Public Builder the option to repurchase finished lots. Off-balance-sheet financed projects will be subject to the same policy requirements as conventionally financed projects.

b. Investment Criteria

(1) Project size shall be limited to the same criteria as above. The Staff has the discretion to approve larger projects after reviewing investment parameters; and

(2) Each investment shall be required to produce a minimum real rate of return (after fees) of 7%.

4. Unentitled Land

a. "Unentitled Land" refers to land that complies with the general plan but does not have a tentative map, specific plan approval, zoning, or a development agreement from the governing jurisdiction.

b. Investment Criteria

(1) Generally, project size shall be limited to the same criteria as Housing Joint Venture and Land Development. The Staff review of investment parameters; and

(2) Each investment shall be required to produce a minimum real rate of return (after fees) of 10%.

5. Entity Level Investments

a. "Entity Level Investments" refers to investments in debt, equity, or hybrid securities of entities whose principal assets are residential real estate.

b. Investment Criteria

(1) The System shall not make passive investments in publicly traded securities under this Program.

(2) The minimum real rate of return (after fees) shall be determined on a case-by-case basis, depending on the applicable risk factors and structure of the investment opportunity.

6. Related Investments

a. "Related Investments" refers to other forms of investment not described above, debt or equity, related to Housing Joint Ventures, Land Development, Off-balance-sheet Financing, Unentitled Land, or Entity Level Investments.

b. Investment Criteria

(1) Generally, project size shall be limited to the same criteria as Housing Joint Venture and Land Development. The Staff has the discretion to approve larger projects after reviewing investment parameters; and

(2) The minimum real rate of return (after fees) shall be determined on a case-by-case basis, depending on the applicable risk factors and structure of the investment opportunity.

D. **Structure**

1. Leverage

The System desires an appropriate and diversified use of leverage (e.g., third-party entity, Mello-Roos, or other project financing debt). A range of leverage at investment level and entity level may be used by the System's partners.

The maximum amount of leverage on the Program Portfolio shall be 60% of cost or market value, whichever is greater. Leverage on individual projects shall not exceed 75% of cost or market value, whichever is greater. A temporary out-of-compliance period shall be allowed up to 75% leverage on the Program for no more than a six-month period, in which the General Partner's cash flow projection shows the Program returning to a 60% leverage ratio or less. In the event that the six-month period is not met, or projections exceed the temporary adjustment period, a capital call shall be made on the applicable partner or new investments in the applicable partnership shall cease. Unentitled Land shall not be leveraged unless it is favorable, non-recourse seller financing.

2. Equity

Equity requirements shall be set by the Program Guidelines. The System recognizes that the financing markets for homebuilding projects are dynamic; therefore, the System shall review and reconsider the equity requirements, as set forth in the Program Guidelines every six months.

E. **Vehicles**

Limited partnerships, limited liability companies, real estate operating companies, commingled funds, and separate accounts shall all be considered appropriate investment vehicles for implementing investments in this property type. However, any such vehicle chosen shall have a finite life and a requirement that the investment be self-liquidating at a time the System considers appropriate. In all cases, the System's investment and risk of loss shall be limited to the amount initially committed. The System and its partners shall structure transactions and utilize vehicles to minimize tax-related issues.

F. **Program Guidelines**

1. The System shall maintain standardized Program Guidelines in the Staff Operations Manual, which establishes operating definitions of program commitment periods, priority returns due the System, and partner fees allowable. Program Guidelines may be changed from time to time in response to changing market conditions.

2. Program parameters in the Program Guidelines shall be developed by the real estate staff and the real estate consultant as appropriate, and are subject to the approval of the Investment Committee. Important program parameters shall include the following:

    a. Program Size - Funds allocated to the market segment;

    b. Timing - Target date for investment of allocated funds;

    c. Diversification - Target allocation of funds among geographic regions and submarkets within the market segment, as appropriate;

    d. Investment Guidelines - Specification of the investment guidelines for acceptable investments within the market segment; and

    e. Asset and Project Management - Specification of the expected value-enhancing activities that shall result in maximizing returns to the System.

3. Unless specifically delegated in the contract, decision making in the Program shall be governed by the Delegations of Authority.

IV. PARTNER RESPONSIBILITIES

A. Responsibility

The partner responsibilities shall include fiduciary responsibility to invest and manage the System's funds in this property type in a manner consistent with the Program Guidelines, as revised from time to time (in effect at the time of each project commitment by a partner), and within the limits set by this Policy.

B. Discretion

The partners shall have investment discretion regarding all project investment decisions; however, they shall comply with the stipulations outlined in the Policy regarding System approvals.

C. Reporting

The System shall require that the partners make periodic reports as requested. The System shall also have the right to audit and review the books, records, and operations of the partners. Such reviews may be conducted either by System Staff or by consultants at the System's discretion.

D. Conflicts of Interest

As part of the partners' standard reporting procedures, the partners shall fully disclose to the System any existing relationships that may qualify as conflicts of interest.

V. GENERAL

Investment in the Program shall include direct or partnership investments where the predominant end-use is for-sale residential property or finished residential lots. This shall include single-family home construction as well as infrastructure development construction (including all forms of acquisition and infrastructure development for single-family housing, such as condominiums, town homes, zero lot line developments, planned unit developments with and without common areas, and standard subdivisions). Incidental commercial/multi-family infrastructure lot development, including golf course construction, may be undertaken in the Program with certain restrictions.

VI. ASSET ALLOCATION

The following is the current asset allocation range for the Program, as a percent of the total allocated Equity Real Estate Portfolio:

	Range
Single-family Housing Program:	5 – 15%

As a percent of the total allocated Specialized Portfolio, this Program shall range from 15 to 35%.

From time to time, the actual investment may fall out of the allocation ranges prescribed by the Policy. In these instances, adjustments to correct the actual to comply with the Policy allocation ranges shall be implemented on an opportunistic basis over a reasonable time frame (normally within a three-year period) and with ample consideration given to preserving investment returns to the System.

VII. PROJECT MANAGEMENT

Management Firms and Partners shall act in a fiduciary capacity, representing the System's interests in project management decisions, and providing daily project management services, as expertise and organizational structure allow. The System shall give appropriate Delegation of Authority to management firms and require that they provide adequate measures of accountability.

A. Investor Approval

The System shall require that it be informed of, but shall not participate in, the resolution of significant events that affect the investment and development process. Examples of these events include significant project cost overruns, schedule delays, contractor disputes, or commencement of litigation, and so forth. The System's approval rights shall be limited to those matters specified in this Policy and the Program Guidelines, approval of partnership level debt, major modifications of the partnership's investment structure, settlement of claims in excess of $500,000, contracts with partners' affiliates, and other major partnership events.

B. Periodic Review

Partner relationships shall be subject to periodic review by the System. System review shall include, but not be limited to, the following:

1. Original project schedules compared to actual deliveries;

2. Actual-compared-to-projected profit margins and absorption rates; and

3. Actual-compared-to-projected returns, current and forecasted capital environments, market conditions, portfolio leverages, portfolio diversifications, and adherence to Policy and Program Guidelines.

VIII. GLOSSARY OF TERMS

The Real Estate Glossary of Terms is referenced in the System's Master Glossary of Terms.